

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-113490-09

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
Year A =
Year B =
Number 1 =
Number 2 =
Number 3 =
Number 4 =
Number 5 =
Number 6 =
Number 7 =
Location A =
Location B =
Location C =

ISSUE:

For purposes of section 168 of the Internal Revenue Code, are Taxpayer's offshore support vessels that are primarily used to transport supplies, equipment, and personnel

in offshore oil and gas operations classified in asset class 00.28, Vessels, Barges, Tugs, and Similar Water Transportation Equipment (except those used in marine construction), or asset class 13.0, Offshore Drilling, of Rev. Proc. 87-56, 1987-2 C.B. 674, as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785?

CONCLUSION:

For purposes of section 168, Taxpayer's offshore support vessels that are primarily used to transport supplies, equipment, and personnel in offshore oil and gas operations are classified in asset class 13.0 of Rev. Proc. 87-56.

FACTS:

Taxpayer owns and operates offshore support vessels that are used to support all phases of offshore oil and gas exploration, development, and production activities. Taxpayer, through its various subsidiaries, enters into time charter arrangements with customers that are engaged in offshore oil and gas operations. Under those arrangements, Taxpayer uses its support vessels to transport supplies, equipment, and personnel in support of all phases of its customers' offshore oil and gas operations. The offshore oil and gas operations of exploration, development, and production each will include drilling activities.

The vessels under charter are crewed by employees of Taxpayer and are used to perform support services at the direction of its customers. Taxpayer's customers specify the location of delivery and select all passengers and cargo. Taxpayer usually does not know whether the support vessels will be directed to provide support to exploration, development, or production locations, or in some combination thereof, or whether drilling activities are occurring at these locations. Moreover, Taxpayer typically does not know who owns the cargo or who employs the personnel being transported, nor does Taxpayer know whether the operations are being conducted by the owner of the well, the owner of the drilling rig, or by a contractor that the owner of the well or drilling rig has hired.

This case involves Number 1 offshore support vessels that were owned and operated by Taxpayer during the Year A and Year B taxable years. The Number 1 offshore support vessels include Number 2 offshore supply vessels and Number 3 offshore crew boats. Supply vessels are used to carry deck cargo, liquid mud, methanol, diesel fuel, and water, while crew boats move personnel between shore-based facilities and offshore platforms and rigs. Number 4 of the offshore support vessels were operated in the Location A and Number 5 were operated in Location B and Location C locations. Out of the Number 1 offshore support vessels, Number 6 are permitted to engage in oilfield services only and are not permitted to engage in general transportation activities. Number 7 of the offshore support vessels are certified to participate in both oilfield services and general marine transportation services, but these vessels have only engaged in offshore oilfield services since being placed in service.

Taxpayer does not maintain records to determine the types of activities (exploration, development, or production, or whether there were any drilling activities occurring) that its offshore support vessels are supporting, nor do Taxpayer's books and records make a distinction between the types of activities supported by the vessels.

LAW AND ANALYSIS:

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in a taxpayer's trade or business.

The depreciation deduction provided by section 167(a) for tangible property placed in service after 1986 generally is determined under section 168. This section prescribes two methods of accounting for determining depreciation allowances. One method is the general depreciation system in section 168(a) and the other method is the alternative depreciation system in section 168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

For purposes of either section 168(a) or 168(g), the applicable recovery period is determined by reference to class life or by statute. Section 168(i)(1) defines the term "class life" as meaning the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under section 167(m) (determined without regard to section 167(m)(4) and as if the taxpayer had made an election under section 167(m)) as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990. Former section 167(m) provided that in the case of a taxpayer who elected the Class Life Asset Depreciation Range ("ADR") system of depreciation, the depreciation allowance was based on the class life prescribed by the Secretary that reasonably reflected the anticipated useful life of that class of property to the industry or other group.

Section 1.167(a)-11(b)(4)(iii)(b) of the Income Tax Regulations provides rules for classifying property under former section 167(m). Property is included in the asset guideline class for the activity in which the property is primarily used. Property is classified according to primary use even though the activity in which the property is primarily used is insubstantial in relation to all the taxpayer's activities.

However, in the case of a lessor of property, section 1.167(a)-11(e)(3)(iii) provides that unless there is an asset guideline class in effect for lessors of such property, the asset guideline class for such property is determined as if the property were owned by the lessee. Section 1.167(a)-11(e)(3)(iii) further provides that in the case of an asset guideline class based upon the type of property (such as trucks or railroad cars) as

distinguished from the activity in which used, the property is classified without regard to the activity of the lessee.

Rev. Proc. 87-56 sets forth the class lives of property that are necessary to compute the depreciation allowance under section 168. This revenue procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific depreciable assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of depreciable assets used in specific business activities. An asset that falls within both an asset group (that is, asset classes 00.11 through 00.4) and an activity group (that is, asset classes 01.1 through 80.0) would be classified in the asset group. See Norwest Corp. & Subs. v. Commissioner, 111 T.C. 105, 156-64 (1998). The asset classes described below are set forth in Rev. Proc. 87-56.

Asset class 00.28, Vessels, Barges, Tugs and Similar Water Transportation Equipment, except those used in marine construction, is not further described by the revenue procedure. Assets in this class have a recovery period of 10 years for purposes of section 168(a) and 18 years for purposes of section 168(g).

Asset class 13.0, Offshore Drilling, includes assets used in offshore drilling for oil and gas such as floating, self-propelled and other drilling vessels, barges, platforms, and drilling equipment and support vessels such as tenders, barges, towboats and crewboats. Oil and gas production assets are excluded from asset class 13.0. Assets in this class have a recovery period of 5 years for purposes of section 168(a) and 7.5 years for purposes of section 168(g).

Asset class 13.2, Exploration for and Production of Petroleum and Natural Gas Deposits, includes assets used by petroleum and natural gas producers for drilling of wells and production of petroleum and natural gas, including gathering pipelines and related storage facilities. Asset class 13.2 also includes petroleum and natural gas offshore transportation facilities used by producers and others consisting of platforms (other than drilling platforms classified in Class 13.0), compression or pumping equipment, and gathering and transmission lines to the first onshore transshipment facility. The assets used in the first onshore transshipment facility are also included and consist of separation equipment (used for separation of natural gas, liquids, and solids), compression or pumping equipment (other than equipment classified in Class 49.23), and liquid holding or storage facilities (other than those classified in Class 49.25). Asset class 13.2 does not include support vessels. Assets in this class have a recovery period of 7 years for purposes of section 168(a) and 14 years for purposes of section 168(g).

Recent appellate decisions discuss the “primary use” standard for asset classification under § 1.167(a)-11(b)(4)(iii)(b). See, e.g., Clajon Gas Co, L.P. v. Commissioner, 354 F.3d 786 (8th Cir. 2004). Courts have concluded that the actual purpose and function of an asset

determines its asset class (a use-driven functional standard) rather than the terminology used to describe an asset by its owners or others.

In the present case, Taxpayer is not engaged in offshore drilling or any other offshore energy activity. Taxpayer is a contractor that uses its support vessels to transport supplies, equipment, and personnel for its customer's offshore oil and gas operations. The Director and Taxpayer agree that Taxpayer's customers are engaged in offshore oil and gas exploration, development, and production. Thus, at issue in this technical advice memorandum is whether asset class 13.0 of Rev. Proc. 87-56 includes support vessels used in all offshore oil and gas operations or support vessels used only in offshore drilling for oil and gas, whether used for the taxpayer's own account or for others.

The plain language, or literal, description of asset class 13.0 of Rev. Proc. 87-56 includes support vessels such as tenders, barges, towboats and crewboats. However, the title, and a closer reading of the description, of asset class 13.0 arguably supports a conclusion that only items of property, including support vessels, primarily used in offshore drilling for oil and gas are included in asset class 13.0. We acknowledge that upon a closer reading of the description of asset class 13.0, it is unclear as to whether or not this asset class includes support vessels primarily used only in such offshore drilling activities. For insight into this question, it is necessary to examine the history behind the development of asset class 13.0 of Rev. Proc. 87-56.

History of Asset Class 13.0

Rev. Proc. 62-21, 1962-2 C.B. 418, set forth guideline lives and rules for depreciation. The revenue procedure, which aggregated assets by industry for depreciation purposes, stated that the guideline lives set forth applied to broad classes of assets rather than to individual assets. Among the four separate groups of assets and the numerous classes within each group set forth by Rev. Proc. 62-21 were the following:

Group One of Rev. Proc. 62-21 covered depreciable assets used by all businesses. Class 2(h) of Group One included vessels, barges, tugs, and similar water transportation equipment.

Group Two of Rev. Proc. 62-21 covered non-manufacturing activities, excluding transportation, communications, and public utilities. Class 2 of Group Two pertained to contract construction, including general building, special trade, heavy construction, and marine contractors. Class 2(a), General Contract Construction, excluded assets used only in marine contract construction. Class 2(b), Marine Contract Construction, included assets used only in marine contract construction.

Group Three of Rev. Proc. 62-21 covered manufacturing. Assets used in the oil and gas industry were included in class 17 of Group Three. A distinction was drawn between, and

different guideline lives were provided for, the drilling equipment of contract drillers and the drilling equipment of producers that performed drilling services for their own account.

Supplement I to Rev. Proc. 62-21, 1963-2 C.B. 740, provided that Class 2(h) of Group One of Rev. Proc. 62-21 excludes barges, boats, and other vessels used in marine contract construction and that these assets are included in class 2(b) of Group Two of Rev. Proc. 62-21.

The proper classification under Rev. Proc. 62-21 of certain assets used in offshore oil and gas operations was addressed by the Internal Revenue Service in Rev. Proc. 66-18, 1966-1 C.B. 646, which provided that:

[f]loating or self-propelled drilling vessels and barges, platforms, and support vessels, such as those used in the exploration of oil or gas in offshore operations, are classified in Group 2, Class 2(b), Marine Contract Construction, with a guideline class life of 12 years. Included is the vessel itself and all drilling equipment related thereto. Tenders, barges, towboats, crew boats and other vessels used to transport supplies, equipment, and personnel in offshore operations are classified in the same class. For activities of this kind, this classification includes equipment used in both force account and contract construction.

Rev. Proc. 72-10, 1972-1 C.B. 721, was published to implement the ADR system authorized by former section 167(m). Among the numerous asset guideline classes set forth by this revenue procedure were the following:

Asset class 00.28, Vessels, barges, tugs and similar water transportation equipment, except those used in marine contract construction.

Asset class 13.2, Exploration for petroleum and natural gas deposits, includes assets used for drilling of wells and production of petroleum and natural gas, including gathering pipelines and related storage facilities, when these are related activities undertaken by petroleum and natural gas producers.

Asset class 15.2, Marine contract construction, includes floating, self-propelled and other drilling platforms used in offshore drilling for oil and gas.

Rev. Proc. 77-10, 1977-1 C.B. 548, superceded Rev. Proc. 72-10 and modified the description of assets included in asset class 15.2 to be consistent with Rev. Proc. 66-18. The other asset classes described above remained essentially the same. Revised asset class 15.2 was described as follows:

15.2 Marine Contract Construction:

Includes assets used by general building, special trade, and heavy construction contractors predominantly in marine construction work. Does not include assets used by companies in performing marine construction services for their own account except for floating, self-propelled, and other drilling platforms and support vessels used in offshore drilling for oil and gas which are included whether used for their own account or others.

Rev. Proc. 78-5, 1978-1 C.B. 557, revised asset class 13.2 of Rev. Proc. 77-10 to include petroleum and natural gas offshore transportation facilities used by petroleum and natural gas producers and others in the offshore pipeline transportation of oil and natural gas. The revenue procedure states that these assets were formerly included in asset class 46.0, Pipeline Transportation. Revised asset class 13.2 read as follows:

13.2 Exploration for and Production of Petroleum and Natural Gas Deposits:

Includes assets used by petroleum and natural gas producers for drilling of wells and production of petroleum and natural gas, including gathering pipelines and related storage facilities. Also includes petroleum and natural gas offshore transportation facilities used by producers and others consisting of platforms (other than drilling platforms classified in Class 15.2), compression and pumping equipment, and gathering and transmission lines to the first onshore transshipment facility. The assets used in the first onshore transshipment facility are also included and consist of separation equipment (used for separation of natural gas, liquids, and solids), compression or pumping equipment (other than equipment classified in Class 49.23), and liquid holding or storage facilities (other than those classified in Class 49.25). Does not include support vessels.

The “others” referred to in the description of asset class 13.2 include pipeline companies. In addition, the first parenthetical in the description makes it clear that drilling contractors’ drilling platforms continued to be included in asset class 15.2.

Rev. Proc. 77-10 was also modified by Rev. Proc. 80-58, 1980-2 C.B. 854, the stated purpose of which was to delete existing asset classes 15.1, Contract Construction other than Marine, and 15.2, Marine Contract Construction, and to establish two new classes for assets used in construction (Class 15.0) and used in offshore oil and gas drilling (Class 13.0). Rev. Proc. 80-58 noted that asset class 15.2 included assets used in offshore oil and gas drilling. The new asset classes established by Rev. Proc. 80-58 were described as follows:

13.0 Offshore Drilling:

Includes assets used in offshore drilling for oil and gas such as floating, self-propelled and other drilling vessels, barges, platforms, and drilling equipment and support vessels such as tenders, barges, towboats and crew boats. Excludes oil and gas production assets.

15.0 Construction:

Includes assets used in construction by general building, special trade, heavy and marine construction contractors, operative and investment builders, real estate subdividers and developers, and others except railroads.

Rev. Proc. 77-10 was superceded by Rev. Proc. 83-35, 1983-1 C.B. 745. Asset classes 13.0 and 15.0 in Rev. Proc. 83-35 were the same as set forth in Rev. Proc. 80-58. Asset class 13.2 was the same as set forth in Rev. Proc. 78-5, as modified by Rev. Proc. 80-58. Rev. Proc. 87-56 contains the same descriptions of asset classes 13.0, 13.2, and 15.0 that are contained in Rev. Proc. 83-35.

Our review of the evolution of the pertinent asset classes indicates that the change created by Rev. Proc. 66-18 was maintained in subsequent revenue procedures through the revenue procedure currently in effect, Rev. Proc. 87-56. Pursuant to Rev. Proc. 66-18, all support vessels used to transport supplies, equipment, and personnel in offshore operations were classified in a single activity class called "Marine Contract Construction," without regard to whether these support vessels were used for the taxpayer's own account or under a contract for others. The phrase "offshore operations," both in terms of its plain meaning and its meaning within the oil and gas industry, encompasses all phases of offshore oil and gas operations, including exploration, development, and production. The support vessels classified by Rev. Proc. 66-18 in the Marine Contract Construction class (former asset class 15.2) were moved to asset class 13.0, Offshore Drilling, by Rev. Proc. 80-58 and are still included in asset class 13.0 of Rev. Proc. 87-56.

The plain language of asset class 13.0 of Rev. Proc. 87-56 includes support vessels such as tenders, barges, towboats and crew boats. Because the support vessels classified by Rev. Proc. 66-18 in the Marine Contract Construction class are currently included in asset class 13.0 of Rev. Proc. 87-56, these support vessels must be used to transport supplies, equipment, and personnel in offshore oil and gas operations, whether used for the taxpayer's own account or for others. It is undisputed that Taxpayer, as a contractor, primarily uses its support vessels in transporting supplies, equipment, and personnel in offshore oil and gas operations, including exploration, development, and production activities, for its customers.

Based on Taxpayer's primary use of its support vessels, the plain language of asset class 13.0 of Rev. Proc. 87-56, and our conclusion that the support vessels classified by Rev. Proc. 66-18 in the Marine Contract Construction class (former asset class 15.2) are currently included in asset class 13.0 of Rev. Proc. 87-56, Taxpayer's support vessels that are primarily used in transporting supplies, equipment, and personnel in offshore oil and gas operations for others are classified in asset class 13.0 of Rev. Proc. 87-56.

In the analysis section of the technical advice memorandum request, the Director posits that all support vessels were originally classified in Rev. Proc. 62-21's two activity classes for oil and gas production, which are Group 3, Class 17(a), Drilling, Geophysical and Field Services and Group 3, Class 17(b), Exploration, Drilling, and Production, and that only support vessels primarily used for offshore drilling were moved to Group 2, Class 2(b), Marine Contract Construction, by Rev. Proc. 66-18.

The express purpose of Rev. Proc. 66-18 was to "provide advice concerning the proper classification in Rev. Proc. 62-21 of drilling vessels and barges, of platforms, and of support vessels." As previously stated, Rev. Proc. 66-18 provided that "[f]loating or self-propelled drilling vessels and barges, platforms, and support vessels, such as those used in the exploration of oil or gas in offshore operations, are classified in Group 2, Class 2(b), Marine Contract Construction, with a guideline class life of 12 years. Included is the vessel itself and all drilling equipment related thereto. Tenders, barges, towboats, crew boats and other vessels used to transport supplies, equipment, and personnel in offshore operations are classified in the same class. For activities of this kind, this classification includes equipment used in both force account and contract construction." The first two sentences use the words "drilling" and "exploration of oil or gas in offshore operations" and, consequently, the assets referred to the first two sentences are limited to those used in offshore drilling for oil or gas. In contrast, the third sentence – the pertinent one in the present case -- makes a general reference to "offshore operations" and, as a result, the assets referred to in the third sentence are not limited to those used only in offshore drilling for oil or gas. Thus, Rev. Proc. 66-18 classified all tenders, barges, towboats, crew boats, and other vessels primarily used to transport supplies, equipment, and personnel in offshore oil and gas operations in the same asset class.

CAVEAT:

Temporary or final regulations pertaining to one or more of the issues addressed in this memorandum have not yet been adopted. Therefore, this memorandum will be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusions in the memorandum. See section 13.03 of Rev. Proc. 2009-2, 2009-1 I.R.B. 87, 103 (or any successor). However, a technical advice memorandum that modifies or revokes a letter ruling or another

technical advice memorandum generally is not applied retroactively if the taxpayer can demonstrate that the criteria in section 13.02 of Rev. Proc. 2009-2 are satisfied.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.